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E.O. 12958: N/A
TAGS: ECON WTRO EFIN EINV CH
SUBJECT: Getting a Piece of the Action: Foreign Banks Try To Get Their Foot in the Door of Chinese Banking

REF: A) Shanghai 1354
B) Guangzhou 5379
C) Beijing 3454

¶1. (U) Summary: Under a five-year transition period in its WTO accession agreement which ends December 11, 2006, the Chinese Government is gradually becoming more liberal in allowing foreign investment to enter China's banking industry. With the Chinese Government opening its RMB currency market later this year, how do foreign banks get into the market? The quick way is for foreign banks to invest in local Chinese banks to access the latter's usually extensive system of bank branches and customer networks. Such strategic investment can also effectively help foreign banks to circumvent the Chinese Government's barriers to slow the growth of the foreign banking sector through licensing procedures as well as the difficulties most foreign banks face in accumulating RMB deposits with their few branches. End Summary.

¶2. (U) Economic Minister Counselor Robert Luke and Congenoff met with Milton Lau, General Manger of Citigroup's Guangzhou Branch, and Professor Lu Jun, Dean of the Finance Department of Lingnan College of Dr. Sun Yat Sen University in late February. Interlocutors discussed their opinions on China's opening of the banking industry.

Restricting Trade: Control through Indirect Means

¶3. Administrative barriers govern foreign bank expansion at present. According to Citigroup's Lau, RMB business is currently restricted. Foreign banks, with only a two percent share of the banking sector, are eager to get a larger share. Even if there were an RMB license available, only 20 cities in China are approved for foreign banks to offer RMB transactions. Currently, RMB services by foreign banks are only allowed for foreign customers. According to Lau, whenever a foreign bank wants to open a new bank branch or launch a new product, it will face delays due to lengthy application and permit procedures. Lau mentioned another foreign bank that was delayed for six-nine months in opening a branch office. And approval is not an approval. After leasing an office, installing IT systems, and providing training, the local China Banking Regulatory Commission (CBRC) office then does an on-site inspection. Only then is a final license issued. Large capitalization requirements

are also required as per CBRC requirements, depending on the level of services provided. For each additional sub-branch an additional RMB 10 million (USD 1.25 million) is required. To provide foreign currency trading, RMB 100 million (USD 12.5 million) is required. To provide RMB banking business services to individuals, a foreign bank needs to have RMB 200 million (approximately USD 25 million) in operating capital. For comprehensive RMB services for businesses, RMB 300 million (USD 38 million) is required. Lu Jun also noted that even if a bank obtained approval for opening a new branch, it may still face zoning restrictions, limiting the number of banks that can be allowed within a certain geographic area. Starting December 11, at the end of China's WTO transition period, the Chinese Government will fully open its banking industry and lift all current geographical and product restrictions on foreign banks.

Domestic Banks are the Most Efficient Choice For Expansion
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¶4. (U) To work locally, foreign banks need access to local currency, i.e., RMB. RMB most commonly comes from local depositors. Without access to local depositors, banks could use interbank lending to get access to RMB but would be at a competitive disadvantage from the start due to the higher acquisition costs. Ready access to RMB would also allow foreign banks to offer loan services to a sector that had defaulted on them earlier. Though many foreign banks, including Citigroup, had earlier suffered from bad loans to some of China's large state-owned enterprises (SOEs), in recent years, according to Lau, foreign banks have found that large reformed SOEs to have become good customers. Since domestic banks have a long tradition of providing the majority of their loans to SOEs, these banks have very

close, long-term relations with the big SOEs. Additionally, domestic banks holding full business licenses already maintain a far-flung branch network with ready access to local depositors. China is already well known as a country with a savings rate as high as 40-50 percent with banks awash in cash. Lu noted that management, not finance, is the problem with domestic banks. Buying into domestic banks can provide foreign banks with the fastest access to the local market, especially in getting RMB deposits after November 1. The current average three percent gap between the deposit and loan interests also make the RMB currency market very attractive to foreign banks. Investing in a domestic bank with its built-in advantages is the most efficient and cost-effective way for foreign banks to expand in China.

But No Free Lunch: Citigroup Plays Catch-up To Rivals
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¶5. (U) All of this opportunity comes with costs and limitations. Some domestic banks carry a high percentage of non-performing loans, so acquiring a share of a domestic bank often means acquiring a net negative value, though it obviously is not entirely without value. In theory, each foreign bank is only allowed to invest in two domestic banks. Citigroup is trying to catch up with rivals in China such as HSBC Holdings, which already has a bigger stake in China's financial sector. Citigroup has already invested in Shanghai Pudong Development Bank with a 4.6 percent share, is in negotiations for an increased share, and is currently bidding for a significant share of Guangdong Development Bank (GDB). Lu's understanding is that GDB's capitalization rate is already negative seven percent but still described Citigroup's bid as "good risk management." Despite this negative worth, GDB already has a built-in infrastructure that will save Citigroup much money and time it would need for its own expansion with the purchase. The success of Citigroup's bid depends on whether the Chinese regulators make an exception in the ownership cap of 20 percent set for a single foreign firm and 25 percent for collective

ownership. As reported on ref A, Citigroup hopes to acquire a 40 percent stake in GDB. Citigroup believes the Government might still approve the purchase because of the seriousness of GDB's current situation.

Citigroup's Strategy

¶6. (SBU) Lau outlined several steps that Citigroup would take to expand its business. Beginning with its current multinational corporate clients, Citigroup would expand its services to Guangdong's top tier of SOEs and to Taiwan-invested businesses, building on its strong business in Taiwan. Later, Citigroup would develop services specifically for small and medium enterprises (SMEs) and commercial banks; groups Lau said were often ignored by local banks. Lau noted that Citibank Hong Kong already has a well-established SME banking business begun in 2005. This sector has just opened to foreign banks. Citigroup China has promoted the former Guangzhou Citigroup director to be the head of all China commercial banking in an effort to begin planning. Taking a long-term view of the China market, Lau said that both Citigroup and HSBC would expand into consumer banking, an area he suggested few foreign banks would penetrate, preferring to stick with corporate banking.

Encouraging a Foreign Lifeline

¶7. (U) Lu also pointed out the Chinese Government and domestic banks acknowledge the value of attracting foreign investment. The Chinese Government, which formerly held that the banking industry was a strategic sector of the economy and therefore no portion of it could be sold to foreign interests, has seen that keeping domestic banks fully state-owned is not the best way of keeping them

healthy, particularly given their previous track record. Foreign banks offer strategic investment, financial expertise, advanced management, and experience in a competitive global world, all of which domestic banks will need to survive in a more open post-WTO transition period. Starting from January 1, 2007, three weeks after the transition period ends, all domestic banks will be required to meet an eight percent capitalization rate before they can provide new business products, critical for their survival. Foreign banks could provide much of this capital.

Comment: Possible Breakthrough for Mutual Benefit?
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¶8. (SBU) The Chinese Government is protecting its domestic banks by using intangible administrative measures to push up the expansion costs for foreign competitors. Foreign banks' investment in domestic banks will have a win-win effect of providing a fast and comparatively low-cost expansion for foreign banks while bailing out and encouraging the comprehensive upgrading of domestic banks. A successful Citigroup bid for Guangdong Development Bank may open the door to more rapid access to this sector by foreign banks. End Comment.

DONG